Supreme Court, U.S.
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In the

Supreme Court of the United States

JOHN P. KENNEDY, JOHN P. HINDERAKER,
VIRGINIA F. HINDERAKER, et al.,

Petitioners,

v.

VENROCK ASSOCIATES, VENROCK ASSOCIATES II, L.P.,
VENROCK ENTREPRENEURS FUND, L.P., et al.,

Respondents.

Petition for a Writ of Certiorari to the
United States Court of Appeals for the Seventh Circuit

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Whether the Appellate Court applied an improper standard of review by making de novo factual findings in an appeal of a motion to dismiss after determining that the District Court had erred by dismissing all of Petitioners' claims as derivative.

2. Whether the Appellate Court's failure to remand this case for further proceedings violates the due process clause of the United States Constitution after the Appellate Court had determined that the District Court had erred by dismissing all of Petitioners' claims as derivative.

PARTIES TO THE PROCEEDING

Petitioners:

JOHN P. KENNEDY, JOHN PHILLIP HINDERAKER, VIRGINIA F. HINDERAKER, DAVID WALSH, ROBERT WHITNEY, FRANK R. SHIBILSKI, JOHN FEITH, DAVID BRUCK, SANDRA BRUCK, HERTNER ASSOCIATES, INC. DEFINED BENEFIT PLAN, YALE N. KAPLAN TRUST, CHARLES M. STERN TRUST, STONERIDGE PARTNERS, LLC., RANDY GREWALL, RICHARD NEWELL, MARIO GIACONE, JR., ERIC KAPLAN, ALIA GREENFIELD, AMANDA GREENFIELD, MICHELLE GREENFIELD, ASHER GREENFIELD, IAN GREENFIELD, MICHAEL A. BARCLAY, NIKHIL NAGASWAMI, SANDY SUNDRAM, M.D., TIMOTHY J. MCKAY, HUGH G. MCBREEN, GNANESH COOMARASWAMY, IAN ELFENBAUM, FREDERICK H. KOPKO, JR., SAL PULITANO, EDWARD J. WEINER, ALBERT WEINER, RUTH SIEGEL, FLOR WEINER, HOWARD SCHACHTER, DIANE SCHACHTER, JAMES R. STERN, RANDI KAPLAN STERN, JOHN N. STERN, DOT CHIN, CAROLYN R. WOLFE, MATTHEW P. LEVINE, ALAN R. HIRSCH, M.D., THOMAS P. VALENTI, JILL MOORE, VLADIMIR MARINKOVICH, ANTOINE WAKIM, PAUL E. WAKIM, SOFIJA OSTOJIC, DANIEL R. PUCCI, RANDALL B. HABERMAN, RICHARD SCIORTINO, DEANNE DEGRAFF, THOMAS J. WITT, LISA K. WITT, JOEL HABERMAN, NICOLE DeBORTOLO, DANIEL R. MARTIN, MIRA DJORDJIC, JEFFREY R.

WESCOTT, MAURA ANN McBREEN, THOMAS J. BRADLEY, PAUL J. McBREEN, ANNIE K. STROBL, SIOBHAN McBREEN BURKE, DEIRDRE F. McBREEN, DOUGLAS M. MILLER, NICK NACHICH, BOSCO MOMICH, SIMEONA MOMICH, EDWARD MILLER, ESTATE OF DONALD H. BROUDY, JOEL E. COHEN, ESTATE OF ADAM J. RICE, JAMES N. DAY, ALVIN B. GALUTEN, BRUCE E. MATES REVOCABLE TRUST DATED JULY 24, 1996, GORDON EVANS, JUDY EVANS, JESSE GREENFIELD I.R.A., GREENFIELD CHILDREN'S PARTNERSHIP, EJADA LIMITED PARTNERSHIP, ALEXIS J. RIVERA, DEBORAH V. RIVERA, ROBERT K. SAVAGE, J. FELIX CAMPOS, JOYCE CAMPOS, CHARLES WATTERSON, KAREN WATTERSON, ROBERT GILMAN, GERARDO A. ACOSTA, BILLIE D. ENNIS, KATHRYN M. ENNIS, MICHAEL MOSES, MARY MOSES, STEPHEN M. BROWN, SCOTT N. FLANDERS KENNETH J. ACKERMAN, JASNA SRECKOVIC, DRAGISA MIRJANICH, GORDANA MIRJANICH, GEORGE SRECKOVIC, VUKASIN PAVLOVIC, MIROSLAV JAKSIC, and GUNNALLEN FINANCIAL, INC.

Respondents:

VENROCK ASSOCIATES, VENROCK ASSOCIATES II, L.P., VENROCK ENTREPRENEURS FUND, L.P., HAMBRECHT & QUIST CALIFORNIA, H&Q EMPLOYEE VENTURE FUND 2000, L.P., ACCESS TECHNOLOGY PARTNERS II, L.P., ACCESS TECHNOLOGY PARTNERS BROKERS FUND, L.P., H&Q CADANT INVESTORS, L.P., CHASE

EQUITY ASSOCIATES, L.L.C., J.P. MORGAN PARTNERS, LLC., KB PARTNERS VENTURE FUND II, L.P., KB PARTNERS AFFILIATES FUND II, L.P., ERIC COPELAND, C.H. RANDOLPH LYON, STEPHAN OPPENHEIMER, KEITH BANK, CHARLES WALKER, and VENTURE LAW GROUP

CORPORATE DISCLOSURE STATEMENT

GunnAllen Financial, Inc. is a subsidiary of Gunn Allen Holdings, Inc. J.P. Morgan Chase & Co. is the parent of Hambrecht & Quist California. J.P. Morgan Chase & Co. owns more than 10% of Hambrecht & Quist California's stock.

TABLE OF CONTENTS

Page

QUESTIONS PRESENTED i

PARTIES TO THE PROCEEDING ii

CORPORATE DISCLOSURE STATEMENT v

TABLE OF AUTHORITIES viii

OPINIONS BELOW 1

JURISDICTION 1

RELEVANT PROVISIONS 1

STATEMENT 3

REASONS FOR GRANTING THE WRIT 8

I. Certiorari Should Be Granted Because the Decision of the Court of Appeals Conflicts With Relevant Decisions of this Court 8

II. Certiorari Should be Granted Because the Decision of the Court of Appeals Results in a Violation of Due Process 10

CONCLUSION 13

APPENDIX

CIRCUIT COURT DECISION 1a

DISTRICT COURT DECISION 20a

ORDER DENYING REHEARING 26a

TABLE OF AUTHORITIES

Page

Cases

ANDERSON V. BESSEMER CITY, 470 U.S. 564, 574-75 (1985) 9

FOMAN V. DAVIS, 371 U.S. 178 (1962) 12

ICICLE SEAFOODS, INC. V. WORTHINGTON, 475 U.S. 709, 714 (1986) 9

LEATHERMAN V. TARRANT COUNTY NARCOTICS INTELLIGENCE AND COORDINATION UNIT, 507 U.S. 163 (1993) 9, 11

ROTELLA V. WOOD, 528 U.S. 549, 560 (2000) 10, 11

TRUAX V. CORRIGAN, 257 U.S. 312 (1921) 11

UNITED STATES V. GAUBERT, 499 U.S. 315, 327 (1991) 9

Statutes

28 U.S.C. 1254(1) 1

Constitutuional Provisions and Other Authorities

Amendment V to the United States Constitiution 1

Fed.R.Civ.Proc. 4(m) 4

Fed.R.Civ.Proc. 11(b)(3) 2, 10, 11

Fed.R.Civ.Proc. 15(a).....3, 12

PETITION FOR WRIT OF CERTIORARI

The Petitioners herein pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Seventh Circuit entered in the above entitled cause on October 29, 2003 and the order entered pursuant to Petitioners' motion for rehearing entered November 18, 2003.

OPINIONS BELOW

The October 29, 2003 opinion of the Court of Appeals, whose judgment is herein sought to be reviewed, is reprinted in the Appendix to this petition at pgs. 1a-19a. The order issued pursuant to Petitioners' motion for rehearing, entered November 18, 2003, is reprinted in the Appendix to this petition at pgs. 26a-27a. The opinion of the United States District Court for the Northern District of Illinois is also reprinted in the Appendix at pgs. 20a-25a.

JURISDICTION

The judgment of the Court of Appeals was entered on October 29, 2003. A timely petition for panel rehearing was denied on November 18, 2003. The jurisdiction of this Court is invoked pursuant to 28 U.S.C. 1254(1).

RELEVANT PROVISIONS

Amendment V to the United States Constitution

> No person shall be held to answer for a capital, or otherwise infamous crime,

unless on a presentment or indictment of a Grand Jury, except in cases arising in the land or naval forces, or in the Militia, when in actual service in time of War or public danger; nor shall any person be subject for the same offence to be twice put in jeopardy of life or limb; nor shall be compelled in any criminal case to be a witness against himself, nor be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation.

Fed.R.Civ.Proc. 11(b)(3) provides in pertinent part:

> **(b) Representations to Court.** By presenting to the court (whether by signing, filing, submitting, or later advocating) a pleading, written motion, or other paper, an attorney or unrepresented party is certifying that to the best of the person's knowledge, information, and belief, formed after an inquiry reasonable under the circumstances, -
>
> (3) the allegations and other factual contentions have evidentiary support or, if specifically so identified, are likely to have evidentiary support after a reasonable opportunity for further investigation or discovery; and

Fed.R.Civ.Proc. 15(a) provides in pertinent part:

> **(a) Amendments.** A party may amend the party's pleading once as a matter of course at any time before a responsive pleading is served or, if the pleading is one to which no responsive pleading is permitted and the action has not been placed upon the trial calendar, the party may so amend it at any time within 20 days after it is served. Otherwise a party may amend the party's pleading only by leave of court or by written consent of the adverse party; and leave shall be freely given when justice so requires. A party shall plead in response to an amended pleading within the time remaining for response to the original pleading or within 10 days after service of the amended pleading, whichever period may be the longer, unless the court otherwise orders.

STATEMENT

A. Nature of the Case

On January 16, 2002, a civil complaint was filed by Petitioners that charged that Respondents conducted a scheme to defraud Petitioner common stockholders of Cadant, Inc. ("Cadant"). The complaint alleged that Respondents seized control of Cadant through a fraudulent proxy and used their control of Cadant to carry out their scheme to dilute the value of Petitioners' interest while enriching themselves. The complaint charged that Respondents breached their

fiduciary duties to Petitioners under federal securities law and state law principles of fiduciary duty.

B. Course of Proceedings Below

On June 7, 2002, Respondents answered Petitioners' complaint. On June 10, 2002, four Respondents, including Cadant, were dismissed pursuant to Fed.R.Civ.Proc. 4(m). On June 17, 2002, CDX Corporation (f/k/a Cadant, Inc.) filed a voluntary petition for relief pursuant to Chapter 11 of Title 11 of the Bankruptcy Code. On September 17, 2002, Petitioners filed their first amended complaint eliminating Cadant as a nominal defendant and adding two more plaintiffs. The original complaint and the first amended complaint alleged identical counts against the other Respondents. On October 22, 2002, Respondents filed a motion to dismiss which was granted by the District Court based upon the finding that all of Petitioners' claims were derivative in nature and thus belonged to the estate of the debtor. (See Appendix pgs. 20a-25a.) Petitioners' case was therefore dismissed in its entirety. (See Appendix pgs. 20a-25a.)

The Appellate Court found that some claims, specifically those against directors, were non-derivative, but affirmed the dismissal of those claims because it found that Petitioners had not pled fraud with particularity and had failed to prove fraud in the use of the proxy statement. (See Appendix pgs. 1a-19a.) Petitioners filed a petition for rehearing arguing that the Appellate Court overlooked facts and law which would have required a decision other than dismissal. In the alternative, Petitioners requested that the case be remanded to allow the filing of a second

amended complaint. The petition for rehearing was denied. (See Appendix pgs. 26a-27a.)

C. Statement of Facts

Cadant was founded in 1998 by Venkata Majeti ("Majeti") and others to develop and manufacture cable modem termination systems, devices used to provide high-speed Internet access to home computers. In 1999, the company issued approximately $7.0 million in common stock to Petitioners through a series of private placement offerings. The following year the company negotiated a purchase agreement with the corporate Respondents for the purchase of preferred stock totalling $12.0 million. (Hereafter, Venrock Associates, J. P. Morgan and their affiliates will be referred to as the corporate Respondents and the individual defendants will be referred to as the individual Respondents.) In connection with said purchase agreement, the company's board of directors was reconfigured to add two directors designated by the corporate Respondents. In addition, Majeti was required to sign a stock restriction agreement which severely compromised his neutrality as a board member. In September of 2000, another board member representing Petitioners' interests was forced to resign after he protested the board's failure to properly consider an offer letter to buy Cadant for roughly $300 million. He was then replaced on the board by an employee of one of the corporate Respondents.

By the fall of 2000, a majority of the directors of Cadant's board were either employed by the corporate Respondents or were preferred stockholders. Throughout the fall of 2000, the individual Respondents

on the board continued to authorize increases in spending despite their receipt of financial information showing that the company was dangerously close to running out of cash. In November, they rejected a financing proposal from Apex Venture Partners without engaging in good faith negotiations and with the intent to protect the corporate Respondents' existing stake in preferred stock from dilution.

In connection with the annual meeting of stockholders scheduled for December 2, 2000, the individual Respondents on the board caused a proxy statement to be issued which eliminated the company's supermajority voting provision by changing the state of incorporation from Maryland to Delaware. The proxy also was materially defective in that it failed to disclose relevant information regarding the director nominees, their affiliations and share ownership. Furthermore, the proxy omitted any financial information concerning the company and provided no disclosure whatsoever regarding the imminent threat of insolvency.

On January 10, 2001, another designee of a corporate Respondent was appointed to the board. Thereafter, the individual Respondents on the board, who had obvious conflicts of interest, negotiated a bridge loan with the corporate Respondents on terms that were highly favorable to the lenders. (Even the Appellate Court acknowledged that one of the previously "unaffiliated" board members "probably" participated in the loan because the other board members voted him options to purchase common stock in the company.)

A second bridge loan was funded approximately four months later and again the loan was not the product of arms-length negotiation, but was instead on terms dictated by the corporate Respondents through their board designees, the individual Respondents. Ultimately, in late 2001, the individual Respondents on the board approved the sale of the company to Arris Group in exchange for stock worth $55.0 million at the time of the sale, an amount just large enough to satisfy the claims of the company's creditors and the preferred shareholdings of the corporate Respondents.

Petitioners filed an appeal alleging that the District Court erred in dismissing all of Petitioners' claims as being derivative claims belonging to the estate of Cadant where 1) the Petitioner stockholders alleged individual injury resulting from Respondents' asserted manipulation of Cadant so as to dilute the cash value and impinge the voting rights of the Petitioner stockholders and 2) Respondents solicited the stockholders' votes by means of a false and misleading proxy statement as an essential element in effecting their scheme to dominate and control Cadant causing harm to the Petitioner stockholders.

The Seventh Circuit affirmed the District Court's dismissal. The Appellate Court, however, found that some claims, specifically those against directors, were non-derivative. The Appellate Court continued to find that Petitioners had not pled fraud with particularity and had failed to prove fraud in the use of the proxy statement.

Petitioners filed a motion for rehearing alleging that the court's opinion was based upon a

misapprehension of law and fact. They alleged the Appellate Court's finding of no actionable fraud failed to consider the material difference between the Cadant Maryland Charter and the Cadant Delaware Charter. In the alternative, Petitioners requested that the case be remanded for the filing of a second amended complaint. On November 18, 2003 the petition for rehearing was denied.

REASONS FOR GRANTING THE WRIT

I. Certiorari Should Be Granted Because the Decision of the Court of Appeals Conflicts With Relevant Decisions of this Court.

The Appellate Court specifically found that the District Court erred in dismissing all of Petitioners' claims as derivative. However, instead of reversing, in part, and remanding the case for further proceedings before the District Court, the Seventh Circuit made findings of fact and dismissed Petitioners' remaining claims on the merits. The Appellate Court relied upon an improper standard of review; that is, it decided factual issues de novo and also failed to weigh Petitioners' allegations under the proper standard for a motion to dismiss.

First, the Court of Appeals in this case applied a de novo standard of review, instead of a clearly erroneous standard. It substituted its own findings of fact, without even a discussion of the District Court's

findings.[1] As set forth in *Icicle Seafoods, Inc. v. Worthington*, 475 U.S. 709, 714 (1986),

> "If the court of appeals believed the district court had failed to make findings of fact essential to a proper resolution of a legal question, it should have remanded to the district court to make those findings. If it was of the view that the findings of the district court were 'clearly erroneous ... ', it could have set them aside on that basis ... But it should not simply have made factual findings on its own."

See also *Anderson v. Bessemer City*, 470 U.S. 564, 574-75 (1985) (trial judge's major role is determination of fact, with experience comes expertise. Court of appeals duplication is a huge cost of judicial resources.)

The standard of review for a motion to dismiss requires that the court accept as true all factual allegations in the complaint. *Leatherman v. Tarrant County Narcotics Intelligence and Coordination Unit*, 507 U.S. 163 (1993). See also *United States v. Gaubert*, 499 U.S. 315, 327 (1991). Here, the Court of Appeals ignored the boundaries of the scope of review and charged ahead to make factual determinations on their own. It did <u>not</u> find there was no actionable fraud based upon issues of law. Rather, the Appellate Court went through Petitioners' amended complaint (and

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[1] There were no District Court findings of fact concerning the fraud alleged in the non-derivative claims, since the District Court dismissed those claims as derivative without considering any allegations of fraud. (See Appendix pgs. 20a-25a.)

Petitioners' appellate brief) and, instead of allowing the District Court to make findings of fact, and, instead of following the standard requiring that the facts be resolved in the Petitioners' favor, the court weighed the sufficiency of the factual allegations independently. For example, the Appellate Court found that the failure to disclose director conflicts of interest and director preferred stock holdings was, in the Appellate Court's words, "tepid", and the omission of director biographies and financial information was, based on their ultimate ruling, immaterial. The court's method precluded discovery, testimony, and any ability to amend the pleadings. By dismissing the Petitioners' claims on the merits, the Appellate Court blatantly disregarded this Court's ruling that Fed.R.Civ.Proc. 11(b)(3) requires a court, even in a fraud case, to have the flexibility to allow pleadings to stand based on evidence reasonably anticipated after further investigation or discovery. *Rotella v. Wood*, 528 U.S. 549, 560 (2000). Once the Seventh Circuit found that some of Petitioners' claims were non-derivative, the case should have been remanded to the trier of fact.

II. Certiorari Should be Granted Because the Decision of the Court of Appeals Results in a Violation of Due Process.

When the Court of Appeals rejected the District Court's finding that all of the Petitioners' claims were derivative, the case should have been remanded to the District Court for further proceedings. In the alternative, in light of the Court of Appeals' determination that fraud was not pled with particularity, the case should have been remanded to allow the filing of a second amended complaint.

Instead, the Court of Appeals proceeded to dismiss the non-derivative fraud allegations on the merits without allowing Petitioners to 1) amend their complaint, 2) conduct discovery or 3) present factual evidence before the trier of fact.

When the Court of Appeals denied Petitioners' motion for rehearing, wherein Petitioners requested that the case be remanded to allow the filing of a second amended complaint, the Appellate Court arbitrarily denied Petitioners their ability to fully litigate their claims, in violation of the due process clause of the United States Constitution. Although Petitioners believe that the amended complaint did allege fraud with adequate particularity as set forth in detail in their petition for rehearing, in the interest of justice, any defect in pleading should be cured by remanding the case to the District Court to allow Petitioners to replead. See *Leatherman v. Tarrant, supra.* See also, *Rotella v. Wood,* 528 U.S. 549, 560 (2000). (Fed.R.Civ.Proc. 11(b)(3) requires that such claim not be barred.)

The due process clause is a limitation upon the executive, legislative, and judicial powers of the federal government. *Truax v. Corrigan,* 257 U.S. 312 (1921). The due process clause requires that every litigant "... have the protection of his day in court, and the benefit of general law, a law which hears before it condemns, which proceeds not arbitrarily or capriciously, but upon inquiry, and renders judgment only after trial." *Id.* at 331.

Fed.R.Civ.Proc. 11(b)(3) echoes the principle. Decisions on the merits are to be avoided on the basis of

mere technicalities. *Foman v. Davis*, 371 U.S. 178 (1962). Fed.R.Civ.Proc. 15(a). (The right to amend should be freely given when justice requires).

Here, Petitioners could not file an amended complaint after the District Court's opinion. All of their claims were dismissed as derivative in nature, thus all of the claims belonged to the estate of the debtor to be litigated in the bankruptcy forum. But the Court of Appeals disagreed and ruled that not all of the claims were derivative. At that point, the individual claims should have been remanded to the trier of fact for a decision on the merits. Instead, the Court of Appeals improperly made its own findings of facts (see Argument I, above), and denied the claims on the merits. When it refused to allow Petitioners to file a second amended complaint pleading fraud with greater specificity, the Appellate Court effectively precluded Petitioners from litigating their claims. They were arbitrarily denied their day in court, in violation of due process.

CONCLUSION

The Court of Appeals essentially reversed the District Court's opinion dismissing all of Petitioners' claims as derivative. The Court of Appeals subsequent independent findings of fact, as well as its refusal to remand the case to allow Petitioners to file a second amended complaint, violate both due process and decisions of this Court. Certiorari should be granted.

Respectfully submitted,

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(Any footnotes trail the end of each document)

No. 02-4330

UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

JOHN P. KENNEDY, et al.,
Plaintiffs-Appellants,

v.

VENROCK ASSOCIATES, et al.,
Defendants-Appellees.

May 27, 2003, Argued
October 29, 2003, Decided

COUNSEL: For JOHN P. KENNEDY, JOHN P. HINDERAKER, VIRGINIA F. HINDERAKER, DAVID WALSH, ROBERT WHITNEY, Plaintiffs - Appellants: James A. McGurk, Chicago, IL USA. Hugh G. McBreen, MCBREEN, MCBREEN & KOPKO, Chicago, IL USA.

For VENROCK ASSOCIATES, VENROCK ASSOCIATES II, L.P., VENROCK ENTREPRENEURS FUND, L.P., HAMBRECHT & QUIST CALIFORNIA, H & Q EMPLOYEE VENTURE FUND, Defendants - Appellees: David A. Rammelt, KELLEY, DRYE & WARREN, Chicago, IL USA.

For KB PARTNERS VENTURE FUND II, L.P., Defendant - Appellee: Alexander Dimitrief, KIRKLAND & ELLIS, Chicago, IL USA.

JUDGES: Before BAUER, POSNER, and COFFEY, Circuit Judges.

OPINIONBY: POSNER

OPINION: POSNER, Circuit Judge. This is a suit by common shareholders of Cadant, Inc. (now CDX Corporation). The defendants are two corporate entities that we'll call "Venrock" and "J.P. Morgan" and individuals associated with them, but we defer consideration of the individual defendants to the end of the opinion and till then use "defendants" to denote just the entities. The suit is based on federal securities law and state antifraud law. It charges the defendants, though they are not affiliated with each other (an important point to stress, because throughout the plaintiffs' briefs the defendants are lumped together under the name, coined by the plaintiffs' lawyers, "Venrock Affiliates," which is not to be confused with "Venrock Associates," the name of one of the defendants), with having acted "in virtual tandem" to seize control of and plunder Cadant. In doing so they are alleged to have violated the fiduciary duty that they owed the plaintiffs by virtue of having obtained control of the corporation. The plaintiffs, who own roughly a quarter of the company's common stock, seek $ 100 million in damages.

Cadant is in bankruptcy, and the district judge dismissed the complaint on the ground that the plaintiffs' claims, though styled as individual ("direct")

claims, really are derivative claims and thus belong to Cadant. If so, they must be litigated in the bankruptcy court--where the plaintiffs and the other shareholders would have to share any liquidation value with Cadant's creditors, who happen to include the defendants.

We construe the facts as favorably to the plaintiffs as the record, which is limited to the 123-page complaint and the exhibits attached to it, permits, while of course not vouching for the accuracy of the allegations. Cadant was formed in 1998 by Venkata Majeti and others to develop cable modem termination systems, which enable high-speed Internet access to home computers. Though based in Illinois, the company was incorporated in Maryland. Majeti and the other founders received common stock in the new corporation at the outset. The company issued additional stock the next year to the plaintiffs for $ 7-$ 8 million (the exact amount is not in the record). The year after that the company issued the defendants preferred stock for $ 12 million; others received preferred stock as well, but between them the defendants received and still own 90 percent of it. A principal of Venrock, named Copeland, became a member of Cadant's five-member board of directors. The other four board members, however, had no affiliation with either Venrock or J.P. Morgan. The plaintiffs irresponsibly contend that one of the four, a Mr. Rochkind, though unaffiliated with either Venrock or J.P. Morgan, owned some of the preferred stock in Cadant and was therefore "aligned" with the defendants.

The following year, 2000, the board turned down a tentative offer by ADC Telecommunications to buy Cadant for some $ 300 million. Later that year the

board proposed and the shareholders approved the reincorporation of Cadant in Delaware, which provides less protection to minority shareholders than Maryland does.

By thebeginning of 2001, Cadant, like many other start-up companies in Internet-related businesses, was in deep financial trouble. The defendants--having spurned more favorable financing possibilities for Cadant (the leitmotif of this suit is that the defendants, although controlling the company, repeatedly missed chances to sell or finance it that would have saved it from insolvency)--agreed with each other and with the board of directors to make Cadant an $ 11 million bridge loan. (A bridge loan is a short-term loan to tide the borrower over while he seeks longer-term financing.) The loan was for 90 days at an annual interest rate of 10 percent and also gave the lenders warrants (never exercised) that they could use to purchase common stock. The terms were highly favorable to the lenders.

Only about 60 percent of the $ 11 million loan was lent by the defendants. The other owners of preferred stock were eligible to participate in the loan, including the director who though not affiliated with either Venrock or J.P. Morgan owned some of that stock. It is unclear whether he participated in the loan, but probably he did because the board voted him some options to buy common stock in Cadant.

Shortly before the bridge loan was made, a representative of J.P. Morgan had been added to Cadant's board, raising the number of directors to six. And earlier, in September, one of the independent directors had been replaced by an employee of J.P.

Morgan named Lyon, so that half the board was now controlled by the defendants. Shortly afterwards, still another representative of the defendants was added to the board, so that between them the defendants at last controlled a majority of the board's members (four out of seven). But this lasted only until March (2001), by which time Lyon had resigned from J.P. Morgan (the exact date of his resignation is unclear).

Within a couple of months of receiving the bridge loan, Cadant had run through the entire $ 11 million. In May the defendants arranged for a second bridge loan, this one for $ 9 million, which gave the lenders (who again included the defendants) a preference in the event that Cadant was sold or otherwise liquidated: they would be entitled to "an amount equal to 200% of (i) outstanding principal amount of the Loans plus (ii) any accrued but unpaid interest thereon." (On liquidation preferences generally, see Don Clark & Lisa Bransten, "E-Business: Starting Gate," Wall St. J., Mar. 19, 2001, at B6; Colin Blaydon & Michael Horvath, "Liquidation Preferences: What You May Not Know," Venture Capital J., Mar. 1, 2002, p. 45; see also Ravi Chiruvolu, "It May Be Time to Hit the Reset Button on Liquidation Preferences," Venture Capital J., July 2002, p. 28. Of course a "liquidation preference" of sorts is implicit in the status of a lender or a preferred shareholder, since both have priority over common shareholders.) The first loan was then amended to add a (smaller) liquidation preference. The defendants discouraged a search for alternative financing on terms that would have been more favorable to Cadant, because they wanted to suck out Cadant's assets by means of the liquidation preferences.

Cadant defaulted on the second bridge loan. The lenders did not foreclose. Instead Cadant sold its entire assets to a firm called Arris Group in exchange for stock worth at the time of the sale (January 2002) some $ 55 million, an amount just large enough to satisfy the claims of Cadant's creditors and preferred shareholders. The board turned down alternatives that would have been better for Cadant but worse for the defendants, who remember were preferred shareholders but also creditors by virtue of the bridge loans. The sale to Arris was approved by Cadant's board and also, as required by Delaware law and the articles of incorporation, by a simple majority of Cadant's common and preferred shareholders voting together as a single class and a simple majority of the preferred shareholders voting separately. Approval by two-thirds of "of all the votes entitled to be cast on the matter" would have been required had Maryland rather than Delaware corporation law governed Cadant, as it had done originally. Md. Code Ann., Corporations & Associations § 3-105(e). For while Maryland permits a corporation to opt out of the two-thirds requirement, id., § 2-104(b)(5), Cadant had not done so. The record is silent on whose votes were "entitled to be cast on the matter" (just common shareholders, or preferred shareholders as well?), so we do not know the exact change in shareholders' rights that was brought about by the reincorporation.

The Arris stock became the property of the bankrupt estate. But because its price has since fallen by 60 percent (and it is Cadant's only asset), the estate is now worth even less than the claims of the bridge lenders and other creditors; and so the plaintiffs and the other shareholders, including the defendants in their capacity

as owners of preferred stock in Cadant, stand to lose their entire investment. The plaintiffs argue that by becoming creditors the defendants wrongfully appropriated Cadant's value.

When a corporation is injured by a wrongful act but the board of directors refuses to seek legal relief, a shareholder can sue the wrongdoer on behalf of the corporation. Ala. By-Prods. Corp. v. Cede & Co., 657 A.2d 254, 265 (Del. 1995); Rales v. Blasband, 634 A.2d 927, 932 (Del. 1993); Kamen v. Kemper Fin. Servs., Inc., 500 U.S. 90, 95-96, 114 L. Ed. 2d 152, 111 S. Ct. 1711 (1991); In re Abbott Labs. Derivative Shareholders Litig., 325 F.3d 795, 803-04 (7th Cir. 2003); Fogel v. Zell, 221 F.3d 955, 965 (7th Cir. 2000); Stepak v. Addison, 20 F.3d 398, 402 (11th Cir. 1994); see also Parnes v. Bally Entm't Corp., 722 A.2d 1243, 1245 (Del. 1999). Such a suit is known as a derivative suit, and is an asset of the corporation-- which means that if, as in this case, the corporation is in bankruptcy, the suit is an asset of the bankrupt estate. 11 U.S.C. § 541(a)(1); Pepper v. Litton, 308 U.S. 295, 306-07, 84 L. Ed. 281, 60 S. Ct. 238 (1939); Koch Ref. v. Farmers Union Cent. Exch., Inc., 831 F.2d 1339, 1343-44 (7th Cir. 1987); In re Ionosphere Clubs), Inc., 17 F.3d 600, 604 (2d Cir. 1994). As common shareholders of a bankrupt corporation, the plaintiffs very much do not want to be in bankruptcy court, where they would be entitled to nothing until all other claimants to the corporation's assets were paid in full, and so they claim to have individual rather than derivative claims against the defendants, the alleged wrongdoers.

They seek to fit their case into the familiar framework of a suit by a minority shareholder against a majority

shareholder. The latter has a fiduciary obligation to the former. Kahn v. Lynch Commun. Sys., Inc, 638 A.2d 1110, 1113-14 (Del. 1994); In re MAXXAM, Inc., 659 A.2d 760, 771 (Del. Ch. 1995); S. Pac. Co. v. Bogert, 250 U.S. 483, 487-88, 63 L. Ed. 1099, 39 S. Ct. 533 (1919); Pepper v. Litton, supra, 308 U.S. at 306-07; In re Lifschultz Fast Freight, 132 F.3d 339, 344 n. 2 (7th Cir. 1997); Rademeyer v. Farris, 284 F.3d 833, 837 (8th Cir. 2002). The breach of that obligation is a wrong to the minority shareholder rather than to the corporation, since, at least as a first approximation, all it does is redistribute wealth from him to the majority shareholder; it does not reduce the value of the corporation. To force the minority shareholder's suit into the derivative mold would have the paradoxical result that the majority shareholder would be the main beneficiary of any judgment or settlement that resulted from the suit; he would be on both sides of the litigation. But that is not this case.

The question whether a suit is derivative by nature or may be brought by a shareholder in his own right is governed by the law of the state of incorporation, Frank v. Hadesman & Frank, Inc., 83 F.3d 158, 159 (7th Cir. 1996); Bagdon v. Bridgestone/Firestone, Inc., 916 F.2d 379, 382 (7th Cir. 1990); 7547 Corp. v. Parker & Parsley Dev. Partners, 38 F.3d 211, 220-21 (5th Cir. 1994), in this case Delaware. The plaintiffs complain about Cadant's having been reincorporated in Delaware, but that is immaterial so far as the law applicable to the choice between derivative and direct suits is concerned because Maryland uses the same basic approach (albeit formulated somewhat differently) to derivative status as Delaware does. Compare Waller v. Waller, 187 Md. 185, 49 A.2d 449,

452-53 (Md. 1946), and Danielewicz v. Arnold, 137 Md. App. 601, 769 A.2d 274, 284 (Md. App. 2001), with Kramer v. W. Pac. Indus., Inc., 546 A.2d 348, 351 (Del. 1988), and Moran v. Household Int'l, Inc., 490 A.2d 1059, 1070 (Del. Ch. 1985), aff'd, 500 A.2d 1346 (Del. 1985). It is true that Strougo v. Bassini, 282 F.3d 162, 171-72 n. 6 (2d Cir. 2002), conjectured that Delaware may require that the harm to the plaintiff shareholders be different from the harm to the rest of the common shareholders (the "undifferentiated harm" test) for a direct suit to lie, though no Delaware case says this. But probably all that is meant by the reference to "undifferentiated harm" is that if all the common shareholders are harmed equally, the case is unlikely to fit the majority-oppressing-the-minority pattern that allows a direct suit to be brought.

In any event the plaintiffs cannot complain about the application of Delaware law in consequence of the reincorporation of Cadant in Delaware because the very case they rely on to show they're entitled to bring a direct suit is a Delaware case. In re Tri-Star Pictures, Inc., Litig., 634 A.2d 319 (Del. 1993), imposed the fiduciary obligation that a majority shareholder owes minority shareholders on a nonmajority shareholder, Coca-Cola. Tri-Star will not do the trick for the plaintiffs in our case, however. The extension of fiduciary duty by that decision was a modest one, as our plaintiffs' own summary of the case makes clear: "The control and domination by Coca-Cola was established by the shareholder agreements which gave it voting control over 56.6% of the outstanding stock and eight out of ten board seats." If shareholders owning in the aggregate a majority of the corporation's common stock get together and agree to use their control of the

corporation to plunder the minority shareholders, the latter have suffered an individual wrong and can sue the controlling shareholders directly. See also Rabkin v. Philip A. Hunt Chem. Corp., 547 A.2d 963, 969 (Del. Ch. 1986); compare Behrens v. Aerial Communs. Inc., 2001 Del. Ch. LEXIS 80, 2001 WL 599870, at *3, 5 (Del. Ch.). In the case of oppression by a majority created by contract, just as in the case of oppression by a majority based on single ownership, there may have been no injury to the corporation, and therefore no occasion for the filing of a derivative suit. The more valuable a corporation is, the more valuable the control of it is. The controlling shareholders want a larger slice of the pie, not a smaller pie, though if the larger slice of a smaller pie is larger than the smaller slice of a larger pie, they will go for the former.

There are two critical differences between this case and Tri-Star. The first is that there was no agreement between Venrock and J.P. Morgan (nor do they have overlapping ownership or management) to control Cadant, as there was between Coca-Cola and other shareholders, together constituting a majority, to control Tri-Star. The plaintiffs' concocted term "Venrock Affiliates" and the expression "in virtual tandem" are obfuscations intended to conceal the absence of an agreement or conspiracy, nowhere alleged in the complaint and expressly disclaimed in the plaintiffs' reply brief. Venrock and J.P. Morgan, as large investors in Cadant, had parallel interests--that much is certainly true. But if having parallel interests is enough to make investors a control group owing a fiduciary obligation to the other investors, judicial interference in the affairs of corporations will be

enormously magnified. There is no legal or economic basis for extending fiduciary obligation so far.

Second, the defendants were not common shareholders at all, let alone a controlling bloc of them. The statement in the plaintiffs' opening brief that "Venrock Affiliates was a controlling shareholder who owed a fiduciary duty to the other stockholders of Cadant" is nonsense. Remember, there is no such entity, whether loose-knit or tight-knit, as "Venrock Affiliates." The defendants never exercised their warrants to purchase common stock.

If an entity that is not a common shareholder steals a corporation's assets, the corporation is the victim of the wrong and owns the cause of action against the thief. We cannot see what difference it makes whether the thief is a complete outsider or, as in this case, a preferred shareholder, who is a kind of lender, or at least quasi-lender, because on the one hand he has a specified return but on the other hand the return can be changed by the corporation and he has more authority over management than a conventional lender. See, e.g., "Preferred Stock," Management and Technology Dictionary, http://www.legamedia.net/lx/result/match/3216767669113a143fc04522d/index.php ("most people see preferred stock as debt with a tax advantage."); Lee A. Sheppard, "Should Junk Bond Interest Deductions Be Disallowed?" 34 Tax Notes 1142, 1146 (1987); Bruce N. Davis & Steven R. Lainoff, "U.S. Taxation of Foreign Joint Ventures," 46 Tax L. Rev. 165, 219 (1991). Who steals assets of a corporation injures the corporation, and the right of redress therefore belongs to the corporation, and so the plaintiffs could not maintain this suit as a direct suit against Venrock and

J.P. Morgan even if the defendants had conspired with each other to control Cadant and had succeeded in controlling it.

We would have a different case had the defendants exercised their warrants and become common shareholders. That would have diluted the voting power of the plaintiffs vis-a-vis the defendants. Lipton v. News Int'l, Plc., 514 A.2d 1075, 1078-79 (Del. 1986); Reifsnyder v. Pittsburgh Outdoor Advertising Co., 405 Pa. 142, 173 A.2d 319, 322-23 (Pa. 1961); Avacus Partners, L.P. v. Brian, 1990 Del. Ch. LEXIS 178, 1990 WL 161909, at *6-7 (Del. Ch.). It would have redistributed power, and hence potentially wealth, between two groups of common shareholders, injuring one group without, once again, necessarily injuring the corporation. As Lipton and Reifsnyder put it, there would be an injury to the plaintiffs' contractual rights. There was no dilution in this case because the defendants never became common shareholders.

But although this suit thus cannot be maintained as a direct suit against Venrock and J.P. Morgan, remember that the suit is against individuals as well. Cadant's directors are accused of having issued a misleading proxy statement as a result of which the common shareholders, including the plaintiffs, were bamboozled into agreeing to the reincorporation of Cadant in Delaware, which gives shareholders less protection than Maryland does. Directors, like majority shareholders (and thus unlike Venrock or J.P. Morgan), have of course a fiduciary obligation to the shareholders. The charge that Cadant's directors issued a misleading proxy statement in violation of their fiduciary obligation is a legitimate direct claim, In re

Tri-Star Pictures, Inc., Litig., supra, 634 A.2d at 330-32, since the effect of the reincorporation was to reduce the shareholders' power over the corporation's affairs rather than to reduce the value of the corporation. It shows by the way that a direct suit is not necessarily precluded by the common shareholders' having suffered an "undifferentiated harm." They can suffer such a harm without the corporation's being injured. A corporation might be worth as much after the directors decided that shareholders would no longer be entitled to vote on any matter as it had been worth before.

Only there was no fraud, at least no actionable fraud, regarding the reincorporation. The proxy statement contained more than 20 pages on the differences between Maryland and Delaware law, and specifically mentioned that certain transactions that require a supermajority in Maryland can be approved in Delaware by a simple majority. There is no actionable fraud without reasonable reliance, and reliance cannot be reasonable when it presupposes a failure to read clear language. Carr v. CIGNA Sec., Inc., 95 F.3d 544, 547 (7th Cir. 1996); In re Mayer, 51 F.3d 670, 676 (7th Cir. 1995); Jackvony v. RIHT Fin. Corp., 873 F.2d 411, 416-17 (1st Cir. 1989); Zobrist v. Coal-X, Inc., 708 F.2d 1511, 1517-19 (10th Cir. 1983).

The plaintiffs complain about other omissions from the proxy statement as well, concerning Cadant's dismal financial condition, conflicts of interest of directors, and "biographies of directors, director compensation, if any, amount of stock held by officers, directors, and 5% owners, executive compensation, related party transactions, compensation paid to officers and information regarding employment contracts." Such

omissions might or might not be material. Current financial information isn't always material to the election of directors, who after all are not responsible for the day-to-day running of the corporation (it is even less likely to be material to a decision to reincorporate in another state); and so there is no per se rule that financial information must be included in a proxy solicitation-- its materiality must be demonstrated case by case. See Loudon v. Archer-Daniels-Midland Co., 700 A.2d 135, 143 (Del. 1997); compare Arnold v. Soc'y for Sav. Bancorp, Inc., 650 A.2d 1270 (Del. 1994). Failing to mention a director's conflict of interest can make a proxy statement false and misleading, even when the directors are running unopposed, Millenco L.P. v. meVC Draper Fisher Jurvetson Fund I, Inc., 824 A.2d 11 (Del. Ch. 2002), although the potential conflicts alleged here--Lyon's soon-to-be-terminated employment with J.P. Morgan, Copeland's employment with Venrock, and the fact that several directors owned preferred shares--seem pretty tepid.

As for the "biographies," contracts, and other records, we are not told what damaging information these might have revealed that should have been disclosed in the proxy statement. We cannot tell, therefore, whether there might be a viable claim buried somewhere in the quoted passage. What is more, the quotation comes from the plaintiffs' opening brief rather than from their complaint, where no such charge is made. They explain that in their brief they are merely embroidering the terse charge in the complaint that "the Defendant Venrock Affiliates and the First Venrock Bridge Affiliates [another fictitious name] breached their fiduciary duties to Cadant by . . . submitting a proxy statement to the common stockholders of Cadant

containing material omissions and misstatements, for the purpose of removing control of Cadant from the common stockholders." They cite cases that permit plaintiffs to defend against dismissal by alleging in their brief facts consistent with but not contained in the complaint. Albiero v. City of Kankakee, 122 F.3d 417, 419 (7th Cir. 1997); Orthmann v. Apple River Campground, Inc., 757 F.2d 909, 915 (7th Cir. 1985); cf. Pegram v. Herdrich, 530 U.S. 211, 230 n. 10, 147 L. Ed. 2d 164, 120 S. Ct. 2143 (2000); S. Cross Overseas Agencies, Inc. v. Wah Kwong Shipping Group Ltd., 181 F.3d 410, 428 n. 8 (3d Cir. 1999). But such supplementation cannot save the charge if the charge is one of fraud, because a charge of fraud must be pleaded with particularity. Fed. R. Civ. P. 9(b). It is not even enough for the plaintiff to submit affidavits that particularize the complaint's charge of fraud. Miller v. Gain Fin., Inc., 995 F.2d 706, 709 (7th Cir. 1993). A fortiori he cannot use his appeal brief to plead for the first time with the requisite particularity. The complaint must allege "the identity of the person making the misrepresentation, the time, place, and content of the misrepresentation, and the method by which the misrepresentation was communicated to the plaintiff." Sears v. Likens, 912 F.2d 889, 893 (7th Cir. 1990); see also Bankers Trust Co. v. Old Republic Ins. Co., 959 F.2d 677, 682 (7th Cir. 1992); Midwest Commerce Banking Co. v. Elkhart City Centre, 4 F.3d 521, 524 (7th Cir. 1993); DiLeo v. Ernst & Young, 901 F.2d 624, 627 (7th Cir. 1990). "Submitting a proxy statement to the common stockholders of Cadant containing material omissions and misstatements, for the purpose of removing control of Cadant from the common stockholders" does not satisfy this standard. Elsewhere in the complaint the plaintiffs do specify the

time and place of the alleged omissions and misstatements, but do not say what they were.

But in charging that the proxy statement contained material omissions and misstatements, are the plaintiffs charging fraud, and fraud alone? For if not, Rule 9(b) falls out of the picture. Plaintiffs don't have to charge fraud in a case such as this in order to state a claim. Negligent omission of material information from a proxy statement violates both federal securities law, see Section 14(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78n(a); 17 C.F.R. § 240.14a-9; Dasho v. Susquehanna Corp., 461 F.2d 11, 29-30 n. 45 (7th Cir. 1972); Wilson v. Great Am. Indus., Inc., 855 F.2d 987, 995 (2d Cir. 1988); Shidler v. All Am. Life & Fin. Corp., 775 F.2d 917, 926-27 (8th Cir. 1985), and Delaware law, which governs claims for breach of the fiduciary duty of disclosure by directors of Delaware corporations. Oliver v. Boston Univ., 2000 Del. Ch. LEXIS 104, 2000 WL 1091480, at *8 (Del. Ch. 2000). Rule 9(b) is strictly construed; it applies to fraud and mistake and nothing else. Leatherman v. Tarrant County Narcotics Intelligence & Coordination Unit, 507 U.S. 163, 168, 122 L. Ed. 2d 517, 113 S. Ct. 1160 (1993); Pizzo v. Bekin Van Lines Co., 258 F.3d 629, 634 (7th Cir. 2001); Hammes v. AAMCO Transmissions, Inc., 33 F.3d 774, 778 (7th Cir. 1994); In re NationsMart Corp. Sec. Litig., 130 F.3d 309, 315 (8th Cir. 1997). And if both fraudulent and nonfraudulent conduct violating the same statute or common law doctrine is alleged, only the first allegation can be dismissed under Rule 9(b), Lone Star Ladies Inv. Club v. Schlotzsky's Inc., 238 F.3d 363, 368-69 (5th Cir. 2001); In re NationsMart Corp. Sec. Litig., supra, 130 F.3d at 315, though if, while the statute or common law doctrine doesn't require proof of fraud, only a

fraudulent violation is charged, failure to comply with Rule 9(b) requires dismissal of the entire charge. Vess v. Ciba-Geigy Corp. USA, 317 F.3d 1097, 1103-05 (9th Cir. 2003); Shapiro v. UJB Fin. Corp., 964 F.2d 272, 288 (3d Cir. 1992).

The complaint does not charge that the directors' failure to disclose their "biographies" and other information in records and contracts was fraudulent. Although the complaint does state that the defendants' lawyers "knew or should have known that the Proxy Statement was fraudulent and misleading," this does not necessarily mean that all the omissions complained of were fraudulent. In their briefs in this court, however, the plaintiffs make clear that they indeed are claiming that all the omissions were fraudulent. For example, the omissions are discussed in a section of the plaintiffs' opening brief captioned: "The proxy [statement] was fraudulent for a host of reasons not addressed by the district court." It is apparent that if the case were to be remanded, the plaintiffs would try to prove that the omissions were fraudulent, and that they have no alternative theory of liability. If, then, the briefs are treated as amending the complaint to make clear that the omissions are being complained of solely because they were fraudulent, Rule 9(b) has been violated.

It is true that a plaintiff cannot amend his complaint in his appeal brief. Harrell v. United States, 13 F.3d 232, 236 (7th Cir. 1993); Thomason v. Nachtrieb, 888 F.2d 1202, 1205 (7th Cir. 1989). But just as he might make a concession in his brief that showed that his case has no merit, though that might not have been apparent from the complaint, Harrell v. United States, supra, 13 F.3d

at 235-36, so he can be estopped by statements in his appeal brief to deny the interpretation that the brief places on the complaint, if the invocation of estoppel is required for the protection of his opponent. As it is here. A principal purpose of requiring that fraud be pleaded with particularity is, by establishing this rather slight obstacle to loose charges of fraud, to protect individuals and businesses from privileged libel (privileged because it is contained in a pleading). Ackerman v. Northwestern Mut. Life Ins. Co., 172 F.3d 467, 469-70 (7th Cir. 1999); Bankers Trust Co. v. Old Republic Ins. Co., supra, 959 F.2d at 682-83; Vess v. Ciba-Geigy Corp. USA, supra, 317 F.3d at 1104; In re Burlington Coat Factory Sec. Litig., 114 F.3d 1410, 1418 (3d Cir. 1997); Ross v. Bolton, 904 F.2d 819, 823 (2d Cir. 1990). That purpose is thwarted by the filing of a stealth complaint in which allegations of fraud are avoided only to be added later by way of brief or other filing. Such an end run should not be permitted. This conclusion is supported by Nolan Bros., Inc. v. United States for Use of Fox Bros. Constr. Co., 266 F.2d 143, 145-46 (10th Cir. 1959), which holds that the word "fraud" need not appear in the complaint in order to trigger Rule 9(b). Cf. Minger v. Green, 239 F.3d 793, 800-01 (6th Cir. 2001).

Rule 9(b) does not permit us to dismiss the fraud allegations that are based on the failure of the proxy statement to disclose Cadant's financial information and directors' conflicts of interest. But those charges fall, on the merits, with the charge of fraudulent nondisclosure of the reincorporation (which we said was not fraudulent). The key allegation in the complaint against the director defendants is that they "submitted a proxy statement to the common stockholders of Cadant

containing material omissions and misstatements, for the purpose of removing control of Cadant from the common stockholders" (emphasis added). The only "removal of control" charged is the reincorporation of Cadant in Delaware, which reduced the shareholders' control over certain transactions. As to that, the shareholders could not be deceived, because the proxy statement described the consequences of reincorporation at great length. All the other charges in the complaint involve injury to the corporation. The common shareholders were injured by that injury, but that makes their claim against the defendants, the injurers, indirect and so bars their prosecuting the claim outside of the bankruptcy proceeding.

AFFIRMED.

Case No. 02 C 383

UNITED STATES DISTICT COURT
Northern District of Illinois
Eastern Division

KENNEDY et al

v.

VENROCK ASSOCIATES et al

November 27, 2002

On September 17, 2002, plaintiffs John P. Kennedy et al. filed their first amended complaint ("FAC") against defendants Venrock Associates et al. Plaintiffs in this case are common shareholders in CDX Corporation, formerly Cadant, Inc, ("Cadant"), a corporation which is now in bankruptcy. In the FAC, plaintiffs elected to drop Cadant as a party. On October 22, 2002, defendants filed a motion to dismiss the FAC pursuant to Fed. R. Civ. Pro. 12(b)(7), 19(a) and (b). Defendants contend that upon Cadant's bankruptcy filing, plaintiff's claims', which defendant argues are in essence all derivative claims on behalf of Cadant, became exclusively the property of the bankruptcy estate under Section 541 of the Bankruptcy Code 11 U.S.C. 541. This court agrees and for the following reasons, defendants' motion is granted.

There are 19 counts in the FAC. Counts 2, 9, 12-15 state claims against Charles Walker and Venture Law Group, two defendants which have been dismissed pursuant to Rule 4(m), (Dkt. No. 24), and therefore,

those counts need not be addressed. Of the remaining counts, counts 5-8, 11, and 16-19 are each explicitly titled derivative claims. Plaintiffs allege that the denomination of these counts as derivative was "not intended to indicate that these claims were not also personal claims of the plaintiff's." (Pls.' Resp. at 3 n. 1). However, upon review of the substance of the counts 5-8, 11, and 16-19, this court finds them to be derivative in nature. A shareholder derivative suit has dual aspects: first, the stockholder's right to site on behalf of the corporation, and second, the claim of the corporation against directors or third parties. Ross v. Bernhard, 396 U.S. 531, 538 (1970). A shareholder's derivative claim "is not his own but corporation's." Id. at 538-39. Here, these explicitly derivative claims consist of allegations of securities fraud under the Securities Exchange Act, common law fraud, and breach of duty claims. In plaintiffs' statutory and common law fraud claims, plaintiff alleges misrepresentations by defendants to Cadant, which were then relied upon by Cadant during the Series A investment and two Bridge Loans. Plaintiff's do not allege that any misrepresentations were directed to plaintiffs or that plaintiffs relied on any misrepresentations. Likewise, in plaintiffs' derivative breach of duty claims, plaintiffs allege defendants breached their fiduciary duties to Cadant, causing Cadant to suffer certain injury and losses. Accordingly, this court finds counts 5-8, 11, and 16-19 to be derivative claims and thus property of Cadant's bankruptcy estate. Additionally, because the corporation is "a necessary party to the action" and "without it the case cannot proceed," Ross, 396 U.S. at 538-39, plaintiffs' FAC has failed to name an indispensable party - Cadant.

The remaining counts, counts l, 3, 4, and 10 are not explicitly labeled "derivative" and purport to assert individual claims for breaches of fiduciary duty against various defendants. A shareholder may bring a direct action for injuries done to him in his individual capacity if he has "an injury which is separate and distinct from that suffered by other shareholders, or a wrong involving a contractual right of a shareholder, such as the right to vote, or to assert majority control, which exists independently of any right of the corporation." Litman v. Prudential-Bache Properties, Inc., 611 A.2d 12, 15 (Del. Ch. 1992). That is, for a plaintiff to bring an individual action, "he must be injured directly or independently of the corporation." Kramer v. Western Pacific Indus., 546 A.2d 348, 351 (Del. Super. Ct. 1988). (emphasis in original). In determining whether a claim is derivative or direct in nature, this court must look to the nature of the wrong alleged and the relief, if any, which could result if plaintiff[s] were to prevail. Id. at 352. Plaintiffs contend that their allegations in counts 1, 3, 4, and 10 reveal two special injuries inflicted solely upon common shareholders: (i) dilution of their shareholder voting rights, and (ii) singular economic harm to their minority interests. In support of their argument, plaintiffs rely heavily on In re Tri-Star Pictures. Inc., Litigation, 634 A.2d 319 (Del. 1993). The Tri-Star court found that the minority-stockholder suffered an individual injury through cash value dilution because the company exchanged stock for assets of the controlling shareholder at an inflated valuation, causing the minority shareholders' position to drop from 43.4% to less than 20% without any compensation, while the controlling shareholder's interest increased substantially. Id. at 330. The Tri-Star court noted that the individual aspect of a cash-

value dilution injury, where the value of the controlling stockholders' interest is increased at the sole expense of the minority, is quite different from injury sustained by waste of corporate assets, where the value of all stackholders' interests diminishes equally. Id. Plaintiffs in this case, however, have not alleged dilution in value similar to that suffiered by the Tri-Star plaintiffs. Plaintiffs contend that the defendants committed a series of self-dealing fraudulent acts, including conducted the Series A Preferred transaction, rejecting an offer to purchase Cadant, purposely accelerating the spending of Cadant assets, and issuing a proxy statement with material omissions, all with the intent to gain control of Cadant. However, while defendants' alleged self dealing acts may have inflicted injury on Cadant, and all Cadant shareholders, it did not result in independent and unique harm to plaintiffs. Plaintiffs were damaged by defendants' alleged fraud only to the extent of their proportionate interest in Cadant. Therefore, plaintiffs have not established a "singular economic harm" such as that found ire Tri-Star.

Plaintiffs also contend that defendants caused a fraudulent proxy statement, with material omissions, to be distributed to plaintiffs. Again, plaintiffs' claims do not allege voting dilution comparable to that sufferd by the Tri-Star plaintiffs. The Tri-Star court found plaintiffs' voting rights were harmed when the majority shareholder in the case, Coca-Cola, failed to disclose to all other shareholders material factual details of certain transactions with Coca-Cola's subsidiary in order to ensure that minority shareholders would vote in favor of the transactions. Tri-Star, 634 A.2d at 331-32. The subsequently approved transaction diminished the Tri-

Star minority shareholders' voting power "to the point of virtual oblivion," while Coca-Cola, the majority shareholder "suffered no similar loss, but reaped a substantial profit." Id. Under these facts, the Tri-Star court found "unique special harm" to each uninformed shareholder. Id. The situation in this case is significantly distinguishable. The proxy statement in question here sought to re-incorporate Cadant from Maryland to Delaware. Plaintiffs allege the proxy statement failed to disclose that reincorporation from Maryland to Delaware law eliminated super-majority voting, therefore changing the number of votes required to approve corporate action. First, this court does not find that the omission in the proxy statement of this particular difference between Maryland and Delaware law qualifies as a fraudulent misrepresentation. Most significantly, it is not a misrepresentation of any fact. As to the law, defendants did not misinform or mislead plaintiffs as to what law would apply after reincorporation. Failure by defendants to provide further analysis, beyond what was already provided in the proxy, as to whether incorporation under Delaware law would be more or less favorable to plaintiffs under certain circurnstances did not materially and adversely affect plaintiffs' right to cast an informed vote and did riot constitute "improper interference with exercise of the franchise" as was the case in Tri-Star. Id. Further, plaintiffs allege no corporate action after reincorporation which was affected by the elimination of super-majority voting under Delaware law, and plaintiffs have certainly not alleged any unique special harm to them that is not equally shared by Cadant and all shareholders as a result of the allegedly misleading proxy statement. Reinorporation of Cadant under

Delaware law applies equally to all shareholders of Cadant, and does not have a unique impact on plaintiffs. Because this court finds plaintiffs' FAC claims dismissible as derivative, this court need not discuss defendants' additional argument as to joinder of Cadant directors.

For all the above stated reasons, defendants' motion to dismiss is granted. This court finds plaintiffs' claims in the FAC to be derivative in nature and exclusively the property of Cadant's bankruptcy estate, and therefore they must be adjudicated within the context of Cadant's bankruptcy proceeding. This case is dismissed in its entirely. Any pending motions are moot.

No. 02-4330

UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

JOHN P. KENNEDY, JOHN P. HINDERAKER, VIRGINIA F. HINDERAKER, et al.,
Plaintiffs-Appellants,

v.

VENROCK ASSOCIATES, VENROCK ASSOCIATES II, L.P., VENROCK ENTREPRENEURS FUND, L.P., et al.,
Defendants-Appellees.

November 18, 2003, Decided

COUNSEL: For John P. Kennedy, John P. Hinderaker, Virginia F. Hinderaker, David Walsh, Robert Whitney, Plaintiffs - Appellants: Hugh G. McBreen, MCBREEN, MCBREEN & KOPKO, James A. McGurk, Chicago, IL USA.

For Venrock Associates, Venrock Associates li, L.P., Venrock Entrepreneurs Fund, L.P., Hambrecht & Quist California, H & Q Employee Venture Fund, Defendants - Appellees: David A. Rammelt, KELLEY, DRYE & WARREN, Chicago, IL USA.

For Kb Partners Venture Fund li, L.P., Defendant - Appellee: Alexander Dimitrief, KIRKLAND & ELLIS, Chicago, IL USA.

JUDGES: Before Hon. William J. Bauer, Circuit Judge, Hon. Richard A. Posner, Circuit Judge, Hon. John L. Coffey, Circuit Judge.

OPINION: ORDER

On November 12, 2003 plaintiffs-appellants filed a petition for rehearing. All of the judges on the panel have voted to deny the petition. The petition is therefore DENIED.